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MICHAEL RODA

IN THE

Supreme Court of the United States

October Term, 1973

No. 73-1523

HEMPT BROS., INC., *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION OF HEMPT BROS., INC. FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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TABLE OF CONTENTS

	Page
Opinions Below	1
Jurisdiction	2
Statutes Involved in the Case	2
Question Presented	3
Statement of the Case	4
Introduction	4
Statement of Facts	5
District Court Decision	7
Court of Appeals Decision	7
Reasons for Granting the Writ	8
Assignment of income doctrine—Under the assignment of income doctrine one cannot dispose of his right to receive ordinary income and thus avoid being taxed on it	8
Section 351—Neither the provisions of Section 351 nor its legislative history preclude an application of the assignment of income doctrine	10
The assignment of income doctrine applies to Section 351 transferors	14
Conclusion	18
Appendix	
Memorandum Decision of the United States District Court for the Middle District of Pennsylvania	19
Order, Dec. 30, 1972	37
Judgment	38

TABLE OF CONTENTS—(*Continued*)

Page

Opinion of the United States Court of Appeals for the Third Circuit 39

Judgment 59

TABLE OF CITATIONS

Cases Cited:

Alderman, Velma W., 55 T.C. 662 (1971) 12

Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972) 12

Bongiovanni, John P., 30 T.C. Memo. 1124 (1971) 12

Briggs, Thomas W., 15 T.C. Memo. 440 (1956) 17

Burnet v. Leininger, 285 U.S. 136 (1932) 8

Burnet v. Wells, 289 U.S. 670 (1933) 8

Commissioner v. Culbertson, 337 U.S. 733 (1949) 4, 8

Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958) 4, 8, 9, 10, 17, 18

Commissioner v. Sunnen, 333 U.S. 591 (1948) 8

Commissioner v. Tower, 327 U.S. 280 (1946) 8

Corliss v. Bowers, 281 U.S. 376 (1930) 8

Dearborn Gage Co., 48 T.C. 190 (1967) 12

Divine v. U.S., 62-2 U.S.T.C. ¶9632 (W.D. Tenn. 1962) 15, 17

Douglas v. Willcuts, 296 U.S. 1 (1935) 8

Ezo Products Co., 37 T.C. 385 (1961) 12

Foster, T. J., 25 T.C. Memo. 1390 (1966) 12

Harrison v. Schaffner, 312 U.S. 579 (1941) 8

TABLE OF CITATIONS—*(Continued)*

Cases Cited: Page

H. B. Zachry Co., 49 T.C. 73 (1967) 15, 17, 18

Helvering v. Clifford, 309 U.S. 331 (1940) 8

Helvering v. Eubank, 311 U.S. 122 (1940) 8

Helvering v. Horst, 311 U.S. 112 (1940) 8

Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946) 12

Hort v. Commissioner, 313 U.S. 28 (1941) 9

Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner, 341 F.2d 466 (5th Cir. 1965) 15, 16

Kniffen, Arthur, 39 T.C. 553 (1962) 17

Leavitt, Mark O., 31 T.C. Memo 453 (1972) 12

Lucas v. Earl, 281 U.S. 111 (1930) 8, 9

Lusthaus v. Commissioner, 327 U.S. 293 (1946) 8

M. Buten & Sons, Inc., 31 T.C. Memo. 178 (1972) 12

Meeks Motor Freight, Inc., 8 T.C. Memo. 838 (1949) .. 12

McCoy, Robert L., 30 T.C. Memo. 146 (1971) 12

Palmer v. Commissioner, 267 F.2d 434 (9th Cir. 1959) 11

Pittsfield Coal & Oil Co., Inc., 25 T.C. Memo. 11 (1966) 12

Portland Gasoline Co. v. Commissioner, 181 F.2d 538 (1950) 12

Raich, Peter, 46 T.C. 604 (1966) 12, 14, 15

Rooney v. U.S., 305 F.2d 681 (9th Cir. 1962) 11

Sol C. Siegel Productions, Inc., 46 T.C. 15 (1966) 18

Textile Apron Co., Inc., 21 T.C. 147 (1953) 12

Thatcher, Wilford E., 61 T.C. No. 4 (1973) 12

U.S. Asiatic Co., 30 T.C. 1373 (1958) 12

TABLE OF CITATIONS—*(Continued)*

Cases Cited: Page

U.S. v. Basye, 410 U.S. 441 (1973) 8

Watson v. Commissioner, 345 U.S. 544 (1953) 9

Weinberg, Adolph, 44 T.C. 233 (1965) 15

Statutes Cited:

Section 202(c)(3) of the Revenue Act of 1921, 42 Stat. 230 13

26 U.S.C. §351 ..... 2, 4, 10, 14

26 U.S.C. §381 ..... 10, 11, 12, 13

26 U.S.C. §481 14

26 U.S.C. §1031 13

28 U.S.C. §1254(1) 2

Regulations and Revenue Ruling Cited:

Treas. Reg. §1.381(a)-1(b) 10, 11

Treas. Reg. §1.381(a)-1(b)(3) 10

Treas. Reg. §1.381(c)(1)-1(a) 10

Treas. Reg. §1.381(c)(2)-1(a) 11

Treas. Reg. §1.441-1(b)(3) 11

Treas. Reg. §1.446-1(e)(1) 11

Treas. Reg. §1.6012-2(a)(2) 11

Rev. Rul. 73-423, 1973-42 I.R.B. 9 16

Miscellaneous:

Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (3d Ed. 1971) 10

Burke, *Section 351: The Beginning of Life in Subchapter C*, 24 Southwestern L.J. 742 (1970) 16

Paul and Kalish, *Transition from a Partnership to Corporation*, 18 N.Y.U. Inst. of Fed. Tax 639 (1960) 17

Worthy, *I.R.S. Chief Counsel Outlines: What Lies Ahead for Professional Corporations*, 22 J. Taxation 88 (1970) 16

S. Rep. No. 275, 67th Cong. 1st Sess. 11 (1921) 13

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The petitioner, Hempt Bros., Inc., respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on January 14, 1974.

OPINIONS BELOW

The opinion of the Court of Appeals for the Third Circuit appears in the Appendix hereto at pages 39-58. The order, judgment and memorandum opinion of the United States District Court for the Eastern District of Pennsylvania appear in the Appendix hereto at pages 19-38.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on January 14, 1974. This petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED IN THE CASE

The Statute involved in this case is 26 U.S.C. §351 which provides in relevant part:

> No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.
>
> If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—
>
> (1) gain (if any) to such recipient shall be recognized, but not in excess of—
>
> (A) the amount of money received, plus
>
> (B) the fair market value of such other property received; and
>
> (2) no loss to such recipient shall be recognized.
>
> In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall be not taken into account.

QUESTION PRESENTED

Whether accounts receivable earned by a partnership and transferred to a corporation, along with the other business assets of the partnership solely in exchange for the corporation's stock, are excludable from the taxable income of the transferee corporation.

STATEMENT OF THE CASE

INTRODUCTION

At issue is whether accounts receivable transferred by a partnership to Hempt Bros., Inc. (hereinafter referred to as "Hempt Bros.") solely in exchange for Hempt Bros. stock, were taxable to Hempt Bros.

It is Hempt Bros.' position that because all of the events fixing the partnership's rights to receive the accounts receivable had occurred prior to the transfer, the assignment of income doctrine prevented the partnership from shifting the incidence of taxation to Hempt Bros., a separate taxpayer.

The Court of Appeals for the Third Circuit held that on balance the teachings of this Court's decision in *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), and other cases of this Court, which have uniformly applied the assignment of income doctrine to prevent the shifting of income from the person who earned the income to another, give way to the broad congressional purpose of facilitating the incorporation of "going" businesses under 26 U.S.C. 351. (Unless otherwise indicated, all section references are to Title 26 of the United States Code).

It is submitted that the Court of Appeals erroneously carved out an exception to this Court's unbroken line of decisions which have refused to permit the shifting of the incidence of taxation from the person who earned it to another. That a transaction would otherwise qualify under Section 351 is no answer to the "first principle of income taxation" that "income must be taxed to him who earns it." *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949). The Court of Appeals also misconceived the role of Section 351 in facilitating the incorporation of "going" businesses, which Section permits only a limited continuity of interest and does not extend to the shifting of earned income, expense items or accounting methods between the transferor and transferee. The Section 351 corporate transferee and its transferor(s) are separate taxpayers.

This separateness has been carefully preserved in other related areas of the law involving Section 351 and the transfer of earned income items is no exception to such separateness.

STATEMENT OF FACTS

The facts were fully stipulated by the parties.

From 1942 until February 28, 1957, a partnership, consisting of four partners, was engaged in the business of quarrying and selling stone, sand, gravel and slag; the manufacture and sale of ready-mix concrete and bituminous materials and the construction of roads, highways and streets (this partnership will hereinafter be referred to as "Partnership").

Partnership maintained its books and records and filed its partnership tax returns on the basis of a calendar year and on the cash method of accounting so that no income was reported by Partnership until actually received in cash. Accordingly, in computing its income for federal income tax purposes, Partnership did not take uncollected receivables into income and inventories were not used in the calculation of its taxable income, although both accounts receivable reflecting sales already made and physical inventories existed to a substantial extent at the end of each of Partnership's taxable years.

The Internal Revenue Service audited Partnership's federal income tax returns during the period 1953-1956.

On March 1, 1957, the business and assets of Partnership were transferred to Hempt Bros. solely in exchange for Hempt Bros. capital stock.

Among the assets transferred to Hempt Bros. on March 1, 1957, were accounts receivable of $662,824.40. Of said accounts receivable of $662,824.40, the amount of $282,409.57 represented amounts owing for sales and rentals and $390,414.83 represented amounts owing for services with respect to the construction of streets, highways, driveways and similar projects.

From March 1, 1957, Hempt Bros. conducted the business formerly conducted by Partnership.

All the events fixing Partnership's rights to receive the accounts receivable of $662,824.40 had occurred prior to March 1, 1957. Hempt Bros. did not perform any services or furnish any materials in respect of the accounts receivable transferred to it.

Commencing with its fiscal year ending February 28, 1958, and for subsequent fiscal years, Hempt Bros. continued the method of accounting of Partnership. It maintained its books and filed its corporate income tax returns on the cash method and, accordingly, did not take uncollected receivables into income and inventories were not used in the calculation of its taxable income.

In its taxable year ended February 28, 1958, Hempt Bros. collected $533,247.87 of the aforesaid $662,824.40 amount of accounts receivable and included said amount of $533,247.87 in income.

In its taxable years ending February 28, 1959, and February 29, 1960, Hempt Bros. collected the balance of the accounts receivable of $129,576.43 and included said amount in income in computing its federal income tax liability for these taxable years.

As a result of an examination extending over a period of years, the Internal Revenue Service converted taxpayer's method of reporting income from the cash to the accrual basis. It was determined by the Commissioner of Internal Revenue by notice dated September 15, 1964, that the use of the cash receipts and disbursements method of accounting with regard to purchases and sales, without taking into account merchandise on hand at the beginning and end of the year, did not clearly reflect Hempt Bros.' income. Hempt Bros. did not contest such conversion from the cash to the accrual method and agreed that it was proper.

Corporation's income was accordingly adjusted to accrue unreported sales made during the taxable years and to take into account inventories in computing its cost of goods sold.

In converting the corporation's method of reporting income from the cash to the accrual method with respect to purchases and sales, the Commissioner did not adjust Hempt Bros. reporting of the accounts receivable transferred to it by Partnership.

DISTRICT COURT DECISION

The District Court held that Hempt Bros. was taxable upon its collection of accounts receivable transferred to it by Partnership. It also held it had no jurisdiction to consider whether Hempt Bros. was entitled to an opening inventory equal in amount to the inventory transferred to it by Partnership. This latter holding is not involved in this petition.

COURT OF APPEALS DECISION

The Court of Appeals affirmed the District Court's holding on the accounts receivable issue and found that Hempt Bros. was taxable on the accounts receivable transferred to it by Partnership. The Court of Appeals also dealt with the substance of Hempt Bros.' claim on the inventory issue. The Court of Appeals' holding on the inventory issue which was adverse to Hempt Bros. is not involved in this petition.

REASONS FOR GRANTING THE WRIT

The question before the Court of Appeals, namely, whether the assignment of income doctrine precluded the taxing of Hempt Bros. on the accounts receivable transferred to it by Partnership, was essentially one of first impression. Indeed, the Court of Appeals cited no authority in support of its holding that this Court's decision in *Commissioner v. P.G. Lake, Inc., supra,* should give way to the legislative purpose of Section 351.

Assignment of income doctrine—Under the assignment of income doctrine one cannot dispose of his right to receive ordinary income and thus avoid being taxed on it.

Under the assignment of income doctrine, one cannot dispose of his right to receive ordinary income and thus avoid being taxed on it. This rule was first enunciated by this Court in *Lucas v. Earl,* 281 U.S. 111 (1930) and has been applied by this Court in numerous subsequent cases, the most recent one being *United States v. Basye,* 410 U.S. 441 (1973). Where the right to receive income is transferred to another person in a transaction not giving rise to tax at the time of transfer, the transferor is taxed on the income when it is collected by the transferree. *Lucas v. Earl, supra; Helvering v. Horst,* 311 U.S. 112 (1940); *Helvering v. Eubank,* 311 U.S. 122 (1940); *Commissioner v. Culbertson, supra, Corliss v. Bowers,* 281 U.S. 376 (1930); *Burnet v. Leininger,* 285 U.S. 136 (1932); *Burnet v. Wells,* 289 U.S. 670 (1933); *Helvering v. Clifford,* 309 U.S. 331 (1940); *Harrison v. Schaffner,* 312 U.S. 579 (1941); *Douglas v. Willcuts,* 296 U.S. 1 (1935); *Commissioner v. Tower,* 327 U.S. 280 (1946); *Lusthaus v. Commissioner,* 327 U.S. 293 (1946); and *Commissioner v. Sunnen,* 333 U.S. 591 (1948). A variation of the doctrine has been applied when the transferor receives consideration for his right to receive ordinary income. Such con-

sideration is taxable to the transferor at the time of transfer at ordinary income rates on a "substitution for ordinary income" principle. *Hort v. Commissioner*, 313 U.S. 28 (1941); *Watson v. Commissioner*, 345 U.S. 544 (1953) and *Commissioner v. P. G. Lake, Inc., supra*.

The only requisite for the application of the assignment of income doctrine is a transfer of a right to receive ordinary income. There is no requirement of a tax avoidance motive or other type of "sinister purpose" in order to invoke the doctrine. *Lucas v. Earl, supra*. Moreover, the doctrine may be invoked by either the taxpayer or the government. It is not solely available to the government to police anticipatory assignments when it wants to; the doctrine either applies or it doesn't, and its application does not revert to the invoking party.

In *Commissioner v. P. G. Lake, Inc., supra*, this Court applied the assignment of income doctrine to deny capital gain treatment to money received on the sale of carved out mineral payments and to deny the application of the tax-free exchange provisions of the predecessor section to Section 1031, involving "like kind" exchanges (Section 112(b) (1) of the Internal Revenue Code of 1939), to the exchange of an oil payment for a fee interest in real estate. Although the oil payment was an interest in land, the tax-free exchange provisions of Section 1031 were held not to apply "where the effect under the tax laws is a transfer of future income from oil leases for real estate." *Commissioner v. P.G. Lake, Inc., supra* at 268.

Under *Commissioner v. P.G. Lake, Inc., supra*, an exchange of property will not be given effect to shift the incidence of taxation from the transferor to the transferee where it amounts to a mere anticipation of that which, absent the exchange, would be received as ordinary income by the transferor.

The accounts receivable at issue in the instant case are the classic type of ordinary income items to which the assignment of income doctrine applies.

Indeed, a sale by Partnership of the accounts receivable for cash, or a gift by it of the accounts receivable would not have shifted ordinary income recognition to the transferee. Nor should the exchange of the accounts receivable for stock as part of an incorporation under Section 351 alter the result. *Commissioner v. P. G. Lake, Inc., supra.* Section 351 provides no exception to the long standing assignment of income rule that has been enunciated by this Court on so many occasions.

Section 351—Neither the provisions of Section 351 nor its legislative history preclude an application of the assignment of income doctrine.

Under Section 351, no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation where the transferors are in control of the corporation immediately after the exchange.

Section 351 may apply to such varying types of incorporations as: Incorporations of going businesses with the corporate transferee conducting the same business, or not conducting the same business, as that conducted by the transferor; incorporations involving the transfers of one or more going businesses plus the transfers by investors of non-business property such as cash, real estate or securities; incorporations involving the transfer of solely non-business assets. See, Bittker & Eustace, *Federal Income Taxation of Corporations and Shareholders* (3d Ed. 1971) ¶3.01 and cases cited therein.

Under the Internal Revenue Code, the transferor and corporate transferee in all Section 351 transactions are regarded as separate taxpayers with each having a separate identity and separate attributes. For example:

1. net operating losses of the transferor do not carry over to the transferee. See 26 U.S.C. §381; Treas. Reg. §1.381(a)-1(b); Treas. Reg. §1.381(a)-1(b)(3); Treas. Reg. §1.381(c)(1)-1(a);

2. earnings and profits of the transferor do not carry over to the transferee. See 26 U.S.C. §381; Treas. Reg. §1.381(a)-1(b); Treas. Reg. §1.381(c)(2)-1(a);

3. the taxable year of the transferor continues uninterrupted;

4. the corporate transferee has the right to choose its own accounting period (calendar or fiscal year) regardless of the accounting period of the transferor. Treas. Reg. §1.6012-2(a)(2);

5. the corporate transferee has the right to elect its own method of accounting (cash or accrual), irrespective of the method of accounting of the transferor, and its own method of accounting for such items as inventory (LIFO, FIFO, or lower of cost or market) bad debts (specific charge-off method or reserve method) and depreciation (straight line or accelerated). Treas. Reg. §1.441-1(b)(3); Treas. Reg. §1.446-1(e)(1);

6. the Commissioner's statutory authority under Sections 446 and 482 to require a change in accounting method or a reallocation of income and deductions in order to "clearly reflect income," overrides and takes precedence over Section 351, *Palmer v. Commissioner*, 267 F.2d 434 (9th Cir. 1959); *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962);

7. a transfer of property that is being depreciated on an accelerated method by the transferor does not qualify the transferee to continue such accelerated method; it is limited to only the method of depreciation afforded taxpayers initially acquiring used depreciable property.

The government, in recent litigation involving issues related to the issue in the instant case, has successfully established and reaffirmed the separateness of the Section 351 transferor and transferee, and the limited continuity of interest afforded by such Section.

1. The corporate transferee in a Section 351 transaction is a separate taxpayer from that of the

transferor and where a change in the accounting practices of the transferee is made in the first year of the corporation's existence (as in the instant case involving Hempt Bros.), the corporation cannot treat as a preceding taxable year the tax year of its predecessor partnership or proprietorship. *Ezo Products Co.*, 37 T. C. 385, 394 (1961); *Dearborn Gage Co.*, 48 T. C. 190, 200 (1967); *Pittsfield Coal & Oil Co., Inc.*, 25 T. C. Memo 11, 13 (1966); *Textile Apron Co., Inc.*, 21 T. C. 147, 151 (1953).

2. The assumption of accounts payable by a Section 351 corporate transferee (the other side of the transfer of income coin) represents a cost of acquisition of the acquired assets and hence the payables are not deductible by the transferee when it pays them irrespective of whether the transferee is on the cash or accrual method of accounting and irrespective of whether the transferor was on the cash method and had not previously deducted them. *Robert L. McCoy*, 30 T. C. Memo 146, 153 (1971); *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323, 324 (8th Cir. 1946); *U.S. Asiatic Co.*, 30 T. C. 1373, 1380 (1958); *Portland Gasolin Co. v. Commissioner*, 181 F.2d 538, 540 (1950); *Mees Motor Freight, Inc.*, 8 T. C. Memo 838, 840-41 (1949); *T. J. Foster*, 25 T. C. Memo 1390, 1402 (1966); *Mark O. Leavitt*, 31 T. C. Memo 453, 456-57 (1972); *M. Buten & Sons, Inc.*, 31 T. C. Memo 178, 180 (1972).

3. To the extent accounts payable of a Section 351 transferor exceed the basis of the assets transferred, gain is recognized to the transferor. *Peter Raich*, 46 T.C. 604, 611 (1966); *Velma W. Alderman*, 55 T.C. 662, 666 (1971); *Wilford E. Thatcher*, 61 T.C. No. 4 (1973); but see *Bongiovanni v. Commissioner*, 470 F. 2d 921 (2d Cir. 1972), *revg., John P. Bongiovanni*, 30 T.C.Memo. 1124 (1971).

In contrast to the strict preservation of the separateness of the Section 351 transferor and transferee, as

discussed above, Section 381, which applies to certain corporate reorganizations, sets forth a highly detailed statutory mechanism providing for the carryover of tax attributes relating to income, expense and accounting items from the transferor to the transferee, with the transferor stepping into the "tax shoes" of the transferee.

Each of the items or attributes discussed above that does not carry over to a Section 351 transferee does carry over to the Section 381 transferee by statute (and the Regulations thereunder). Congress could have made Section 381 applicable to Section 351 exchanges, but it chose not to do so. Accordingly, one can hardly quarrel with the proposition that Congress intended the continuity of interest in Section 351 to be far more limited in scope than the continuity of interest applying to corporate reorganizations.

The Court of Appeals in reaching its decision relied upon the legislative history of Section 351 and its predecessor. Section 202(c) (3) of the Revenue Act of 1921, 42 Stat. 230, the original predecessor of Section 351, applied to three types of transactions:

1. Like kind exchanges (Section 1031);
2. Corporate reorganizations (Section 368); and
3. Transfers to controlled corporations (Section 351).

In discussing all three of these exchanges, the draftsman stated that no gain or loss is to be recognized in certain classes of exchanges "which will permit business to go forward with the readjustments required by existing conditions." S. Rep. No. 275, 67th Cong. 1st Sess. 11 (1921).

The evolution of Section 351, as shaped by Congress and the courts, shows that income, expense and accounting methods cannot be shifted to another taxpayer in a Section 351 transaction, which in this respect is similar to a Section 1031 like kind exchange. Both Sections 351 and 1031 provide for a much more limited continuity of interest than corporate reorganizations. They do not

extend to the shifting of earned income items between separate taxpayers.

The assignment of income doctrine applies to Section 351 transferors.

It is Hempt Bros.' position that under the assignment of income doctrine, it is not taxable on the accounts receivable of Partnership transferred to it. Such was the income of Partnership, not Hempt Bros., and accordingly should have been taxed to Partnership, which it is noted was open to the government to do.

The Section 351 transferee and its transferor(s) are separate taxpayers and there is no justification for deviating from this treatment in respect of the transfer of earned income items.

The cases relied on by Hempt Bros., at pages 11 and 12 herein, in support of its position, are those in which the government was successful in establishing the separateness of the taxpayers and the limited continuity that Hempt Bros. contends should apply in this case.

In the instant case, moreover, the government properly invoked a rule of taxpayer separateness to prevent a tacking by Hempt Bros. of Partnership's taxable years to make the accounting adjustments afforded by Section 481. The Court of Appeals, in its opinion, adopted this rule of taxpayer separateness but failed to perceive that the separate-taxpayer accounting treatment under Section 481 also pointed toward respecting the separateness of the taxpayers in the case of a transfer of earned income items. It is precisely this separateness that underlies the assignment of income doctrine and prevents the shifting of earned income items between the transferor and transferee.

Nor would a decision of this Court, favorable to Hempt Bros., create a hardship to taxpayers. All a taxpayer-transferor need do is withhold the earned income items and collect them, transferring the net proceeds to the corporation. Indeed, in cases such as *Peter*

Raich, supra (which represented another government victory in sustaining the separateness of the Section 351 transferor and transferee and a taxpayer hardship), the transferor could retain both accounts receivable and accounts payable to avoid income recognition at the time of transfer and to have sufficient funds with which to pay accounts payable. Where, as in the instant case, the taxpayer is on the cash method of accounting, the deduction of the accounts payable would be applied against the income generated by the accounts receivable. Thus, income and expense items would be accounted for when the taxpayer ceases its activities and transfers all or a portion of its business to a separate taxpayer.

It is also noted that the transfer of the net proceeds from the collected accounts receivable (after payment of accounts payable and any resultant income taxes) for stock or as a capital contribution would result in an upward basis adjustment in the transferor's stock. The transfer of the accounts receivable by a cash basis taxpayer, under the Court of Appeals' decision, would not result in an upward basis adjustment in the transferor's stock.

The few cases which have discussed the assignment of income doctrine have indicated it should be applicable to the corporate transferee in a Section 351 exchange. See *Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner*, 341 F.2d 466 (5th Cir. 1965); *Divine v. United States*, 62-2 U.S.T.C. ¶9632 (W.D. Tenn. 1962); *Adolph Weinberg*, 44 T.C. 233, 245 (1965) *aff'd per curiam*, 368 F.2d 836 (9th Cir. 1968) and *H.B. Zachry Co.*, 49 T.C. 73 (1967).

> "Petitioner makes another strong argument that the tax liability should be fixed on Ammann rather than the corporation. It says that the realization by Ammann of the value of the future installments when he received stock of value equal to the future installments brought the transaction within the principles announced by the Supreme Court in *Commissioner*

> *of Internal Revenue v. P. G. Lake, Inc.* Supra. The Supreme Court, in *Lake*, held that if an otherwise non-recognition exchange under Section 112(b) (1) of the 1939 Code also amounts to the 'anticipatory assignment of income', such income is taxable notwithstanding it arises from a non-recognition type of transfer. The Government seems to come just up to the point of conceding this contention. In his brief, the Commissioner says: 'While the rationale of the judicially-formed assignment of income principles would, concededly, seem broad enough to generally encompass a non-recognition type of transfer, . . .' the transfer, pursuant to Section 351, of installment obligations with the inherent deferred gain has probably become so engrained in the law as to be subject to change only by Congress. This seems to downgrade rather severely the conceded effect of a Supreme Court decision because of assertedly contrary decisions by inferior courts and a rather vague legislative history to the contrary."

Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner, supra, at 468-69.

The Government has, over the years, vacillated on the question this Court is being asked to decide with respect to both its litigating position and its private ruling position. For example, the Internal Revenue Service has only recently published a ruling which taxes the transferor of installment receivables owed to the Section 351 transferee at the time of transfer to it. *Rev. Rul.* 73-423, 1973-42 I.R.B. 9. The ruling cites *Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner, supra,* at pages 468-469, in support of its holding. For a discussion of the Government's ruling position see Burke, *Section 351: The Beginning of Life in Subchapter C*, 24 Southwestern L.J. 742, 797 (1970); and, Worthy, *I.R.S. Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 22 J. Taxation 88, 90-91 (1970).

The very cases in support of the Government's position in the instant case are ones it previously lost. See *Arthur Kniffen*, 39 T.C. 553 (1962); *Thomas W. Briggs*, 15 T.C. Memo. 440 (1956) and *Divine v. United States, supra*. Indeed, the known litigating position of the Government, as evidenced by the span of years in which it litigated the very question before this Court, but on grounds other than assignment of income principles, has indicated to commentators that the corporate transferee is not taxable on transferred income items.

> "Logically the previously accrued items of income or deduction should be picked up by the Partnership, either at the time of transition or when the item is finally received or paid. In the case of income, ample authority exists to support this conclusion in the form of the doctrine of anticipatory assignment of income."

Paul and Kalish, *Transition from a Partnership to Corporation*, 18 N.Y. U. Inst. of Fed. Tax 639, 657 (1960).

All of this vacillation has created extreme taxpayer uncertainty in transactions of this kind, and it is precisely this uncertainty which Hempt Bros. is asking this Court to resolve by granting a writ of certiorari in this case.

The Court of Appeals found that accounts receivable are "property" within the meaning of Section 351. But irrespective of whether the accounts receivable are property or not, the rationale of *Commissioner v. P.G. Lake, Inc., supra*, is controlling. If the receivables are not property within the meaning of Section 351, their transfer would be the taxable event for the transferor; if they are property; then their collection by the transferee would be the taxable event for the transferor. For example, in *H.B. Zachry Co., supra*, the Tax Court held that a carved out oil payment was property within the meaning of Section 351, and that the transferor was not taxable in the year of transfer under Section 351, but the Court expressly left open the question of taxation to the transferor in the later

years at the time the oil payments were collected. *H.B. Zachry Co., supra*, n.5. See also *Sol C. Siegel Productions, Inc.*, 46 T.C. 15 (1966).

In summary, Section 351 involves varying types of incorporations between separate taxpayers. Unlike corporate reorganizations which, under Section 381, merge and carry over the attributes of the transferor and transferee, the separateness of the transferor and the Section 351 transferee has been carefully preserved by statute, regulations and the vast body of decisional law.

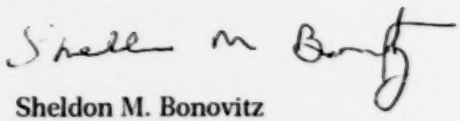
The careful preservation of the separateness of the taxpayers in a Section 351 transaction by Congress and the courts conclusively shows that no exception to the application of the assignment of income doctrine should be carved out from any Section 351 transfers.

This Court's decision in *Commissioner v. P.G. Lake, Inc., supra*, is clearly applicable to Hempt Bros. position, and the decision of the Court of Appeals directly conflicts with its teachings.

CONCLUSION

For all the foregoing reasons, petitioners respectfully request this Honorable Court to grant a Writ of Certiorari upon the United States Court of Appeals for the Third Circuit.

Respectfully submitted,



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Attorneys for Petitioner
Hempt Bros., Inc.

MEMORANDUM DECISION OF THE UNITED STATES DISTRICT COURT FOR THE MIDDLE DISTRICT of PENNSYLVANIA

¶73-631

Hempt Brothers, Inc., Plaintiff v. U.S., Defendant. U.S. District Court, M. Dist. of Pa., No. 68-484 Civil, Feb. 15, 1973.

* * *

James H. King, McNees, Wallace & Nurick, 100 Pine St., Harrisburg, Pa., Sheldon M. Bonovitz, John F. Fansmith, Jr., Duane, Morris & Heckscher, 1617 Land Title Bldg., Broad & Chestnut Sts., Philadelphia, Pa., Attys. for Plaintiff.

S. John Cottone, U.S. Atty., Scranton, Pa., Scott P. Crampton, Asst. Atty. Gen., Tax Div., David A. Wilson, Jr., Chief, Refund Trial Section No. 1, Thomas R. Wechter, Donald R. Anderson, Daniel J. Dinan, Attys., Dept. of Justice, Wash., D.C., for Defendant.

SHERIDAN, Chief Judge:

Plaintiff, Hempt Bros., Inc., seeks to recover income taxes alleged to have been improperly assessed and collected. Jurisdiction is asserted pursuant to 28 U.S.C.A. Section 1346(a)(1). The parties have filed a joint stipulation of facts, and plaintiff has moved for summary judgment. Briefs have been submitted and oral argument made with respect to plaintiff's motion.[1]

1. Both parties have referred to a crossmotion for summary judgment made by defendant. No such motion appears in the record. However, resolution of the legal issues presented is clearly contemplated to the extent permitted by the stipulated facts; and, if appropriate, the court will enter summary judgment for defendant on its own motion. Missouri Pacific Railroad Company v. National Milling Company, Inc., 3 Cir. 1969, 409 F.2d 882, 885; Jackson v. Hammock, E.D.Pa. 1971, 330 F. Supp. 1124; Peoples Trust Company of Bergen County v. United States, D.N.J. 1970, 311 F. Supp. 1197,

From 1942 until February 28, 1957, a partnership comprised of plaintiff's shareholders was engaged in the business of quarrying and selling stone, sand, gravel and slag; manufacturing and selling ready-mix concrete and bituminous materials; constructing roads, highways and streets, principally for the Pennsylvania Department of Highways and various political subdivisions of Pennsylvania; and constructing driveways, parking lots, street and water lines, and related accessories. The partnership maintained its books and filed its partnership income tax returns on a calendar-year basis pursuant to the cash method of accounting. Accordingly, it included neither uncollected receivables nor inventories in its calculation of taxable income, although both items existed to a substantial extent at the end of each year.[2]

On March 1, 1957, the partnership's business and most of its assets were transferred to plaintiff solely in exchange for plaintiff's capital stock; neither gain nor loss was recognized upon the exchange. Int. Rev. Code of 1954, Section 351(a). Among the assets transferred were accounts receivable of $662,824.40 and inventories of $351,266.05.

Subsequent to the transfer, Hempt Bros., Inc. continued the business formerly conducted by the partnership. It reported its income on a fiscal-year basis commencing the first day of March. For all relevant years, plaintiff maintained its books and reported its income in accordance with the cash method of accounting. Amounts due on accounts receivable transferred from its predecessor were collected by the corporation and reported as corporate income in the year of collection. Plaintiff performed no other services with respect to the receivables.

Note 1—*Continued*

1201 aff'd. 3 Cir. 1971, 444 F.2d 193; DeFelice v. Philadelphia Board of Education, E.D.Pa. 1969, 306 F. Supp. 1345, 1348, aff'd per curiam, 3 Cir. 1970, 432 F.2d 1358; United States v. Cless, M.D.Pa. 1957, 150 F. Supp. 687, aff'd, 3 Cir. 1958, 254 F.2d 590.

2. The propriety of the partnership's method of accounting is not in issue.

As a result of an examination extending over a period of years the Commissioner of Internal Revenue[3] determined that plaintiff's accounting method did not clearly reflect income. The corporation therefore was required to use the accrual method commencing with its first taxable year,[4] and adjustments were made to accrue unreported sales and to account for inventories in computing the cost of goods sold. Plaintiff's opening inventory for its first taxable year was valued at zero, and the result was an increase in taxable income for that year.

Hempt Bros., Inc. filed timely refund claims with respect to each of its first three taxable years in which it contended, inter alia, that amounts collected on transferred accounts receivable should be excluded from its income because the partnership performed all the services upon which the right to collection depended, and that its initial opening inventory should be valued at not less than $351,266.05 in order to consistently account for beginning and ending inventory during its first taxable year. Each claim was disallowed in full, and plaintiff then instituted this action to recover alleged overpayments.

With respect to the transferred accounts receivable, plaintiff argues that they are not "property" within the meaning of Section 351(a) and that the partnership therefore realized recognizable income at the time it exchanged them for plaintiff's stock; that the rule enunciated in Commissioner v. P. G. Lake, Inc.[5] requires attribution of ordinary income to the partnership at the time of the exchange; that the assignment-of-income doctrine requires its prede-

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3. Hereinafter "Commissioner."

4. The parties agree that the Commissioner's determination was proper.

5. 1958, 356 U.S. 260 78 S.Ct. 691, 2 L.Ed. 2d 743. In Lake, it was held that the transfer of an income interest in land, e.g., a carved-out oil payment, in exchange for consideration equivalent to the present value of future payments derivable therefrom constituted ordinary income to the transferor and not capital gain. It was also decided that a similar assignment in return for an interest in real estate was not a like-kind exchange.

cessor to recognize income as amounts are collected by plaintiff; that attribution of collections to plaintiff is improper because inconsistent with its accrual method of accounting; and that the individual partners should be responsible for the accounts receivable because the amount of plaintiff's stock which each partner received was allocated pursuant to proportional interests in the partnership's capital account rather than with reference to individual shares in transferred income items. These points will be discussed seriatim.

The meaning of "property" is not defined by Section 351; however, known inclusions and exclusions suggest that the term encompasses whatever may be transferred,[6] including accounts receivable. Burke, Section 351: The Beginning of Life in Subchapter C, 1970, 24 Sw.L.J. 742, 747-48; see Bongiovanni v. Commissioner, 470 F.2d 921 (2 Cir., filed Dec. 11, 1972); P. A. Birren & Son, Inc. v. Commissioner, 7 Cir. 1940, 116 F.2d 718; Peter Raich, 1966, 46 T.C. 604; Pittsfield Coal & Oil Company, Incorporated, 1966, 25 CCH Tax Ct. Mem. 11; Arthur L. Kniffen, 1962, 39 T.C. 553; Ezo Products Company, 1961, 37 T.C. 385; Thomas W. Briggs, 1956, 15 CCH Tax Ct. Mem. 440; Wobbers, Incorporated, 1932, 26 B.T.A. 322; Charles F. Meagher, 1930, 20 B.T.A. 68; cf. Halliburton v. Commissioner, 9 Cir. 1935, 78 F.2d 265, 268-270; American Bantam Car Company, 11 T.C. 397, 403, aff'd per curiam, 3 Cir. 1949, 177 F.2d 513, cert. denied, 1950, 339 U.S. 920, 70 S.Ct. 622, 94 L.Ed. 1344. But see Merchants Bank Bldg. Co. v. Helvering, 8 Cir. 1936, 84 F.2d 478, 481; Note, Section 351 of the Internal Revenue Code and "Mid-Stream" Incorporations, 1969, 38 U.-Cin.L.Rev. 96, 106-07. There is a compelling reason to construe "property" to include potential income items: a new corporation needs working capital, and accounts receivable can be an important source of liquidity. Cf. Halliburton v. Commissioner, 9 Cir. 1935, 78 F.2d 265, 269-70; Bittker, The Corporation and the Federal Income Tax: Transfers to a Controlled Corporation, 1959 Wash. U.L.Q. 1,7.

6. H. B. Zachry Company, 1967, 49 T.C. 73, 80 n. 6.

Lake is not on point because it does not involve the issue of income recognition upon the exchange of an item of potential income for stock in a controlled corporation. H. B. Zachry Company, 1967, 49 T.C. 73, 79-80. As the legislative history of a predecessor to Section 351[7] makes clear,[8] the purpose of the provision is to facilitate movement into the corporate form by preventing immediate recognition of gain or loss when there has been a mere change in the form of ownership. Helvering v. Cement Investors, Inc., 1942, 316 U.S. 527, 533, 62 S.Ct. 1125, 86 L.Ed. 1649; Bongiovanni v. Commissioner, 470 F.2d 921 (2 Cir., filed Dec. 11, 1972); Estate of Walling v. Commissioner, 3 Cir. 1967, 373 F.2d 190, 194; Mather & Co. v. Commissioner, 3 Cir., 171 F.2d 864, cert. denied, 1949, 337 U.S. 907, 69 S.Ct. 1049, 93 L.Ed. 1719; Portland Oil Co. v. Commissioner, 1 Cir., 109 F.2d 479, 488, cert. denied, 1940, 310 U.S. 650, 60 S.Ct. 1100, 84 L.Ed. 1416. Therefore, when a cash-method taxpayer transfers accounts receivable to a controlled corporation solely in exchange for securities therein, the recognition of any gain realized upon the exchange is deferred. Arthur L. Kniffen, 1962, 39 T.C. 553; Charles F. Meagher, 1930, 20 B.T.A. 68. This best comports with the policy of Section 351. Dauber, Accounts

7. Int. Rev. Code of 1921, ch. 136, Section 202(c)(3), 42 Stat. 230.

8. S.Rep. No. 275, 67th Cong., 1st Sess. 11 (1921):

"Section 202 (subdivision c) provides new rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit. . . . The existing law makes a presumption in favor of taxation. The proposed act modifies that presumption by providing . . . certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value. These classes comprise the cases . . . where an individual or individuals transfer property to a corporation and after such transfer are in control of such corporation.

"The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, . . . permit business to go forward with the readjustments required by existing conditions. . . ."

Receivable in Section 351 Transactions, 1966, 52 A.B.A.J. 92; Hickman, Incorporation and Capitalization, 1962, 40 Taxes 974, 979; Riebesehl, Tax-Free Incorporations Under Section 351, 1968, 46 Taxes 360.

However, the question of non-recognition upon the exchange itself is distinct from the issue whether the partnership or the corporation is taxable when collections upon transferred receivables are made. H. B. Zachry Company, 1967, 49 T.C. 73, 80n. 5. Plaintiff contends that such amounts are properly attributable to its predecessor at the time of collection because the partnership performed all the services upon which the right to paying depends.[9]

There is a tension which inheres in Section 351: although its animating concept is that of a mere change in form of ownership, the act of incorporation yields an entity distinct from its predecessor which may independently select many of its characteristics, e.g., its accounting period and its methods of accounting, depreciation and inventory valuation. White, Sleepers That Travel With Section 351 Transfers, 1970, 56 Va.L.Rev. 37. Therefore, it would be erroneous to assume that the assignment-of-income doctrine is necessarily inapplicable. Biblin, Assignments of Income in Connection with Incorporating and Liquidating Corporations, 1969, 21 U.So.Cal.Tax Inst. 383, 385-87. However, for reasons to be enumerated, the court holds that Hempt Bros., Inc. is properly taxable upon collections made with respect to accounts receivable which have been transferred to it in conjunction with the Section 351 incorporation of a going business by a cash-method partnership for a legitimate business purpose.

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9. See, e.g., Lucas v. Earl, 1930, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731. The assignment-of-income doctrine is a common-law acknowledgment that the dominant purpose of the revenue laws is the taxation of income to those who earn it or who otherwise create the right to receive and to enjoy the benefit of it when paid, rather than to tax a mere collector or conduit through whom income passes. Helvering v. Horst, 1940, 311 U.S. 112, 119, 61 S.Ct. 144, 85 L.Ed. 75.

The market value of the receivables notwithstanding, they had a basis of zero to the partnership because no collections were made prior to the transfer. Bongiovanni v. Commissioner, 470 F.2d 921 (2 Cir., filed Dec. 11, 1972); P. A. Birren & Son, Inc. v. Commissioner, 7 Cir. 1940, 116 F.2d 718, 720 [26 AFTR 197]; Peter Raich, 1966, 46 T.C. 604, 610; Note, Section 357(c) and the Cash Basis Taxpayer, 1967, 115 U.Pa.L.Rev. 1154, 1165. Since the exchange was solely for stock, plaintiff's carryover basis was also zero. Int.Rev.Code of 1954, Section 362(a), *as construed in, e.g.*, Ezo Products Company, 1961, 37 T.C. 385, 392-93. Upon collection, plaintiff realized income which it must recognize to the extent that the amounts received exceed basis. P. A. Birren & Son, Inc. v. Commissioner, 7 Cir. 1940, 116 F.2d 718, 720; Thomas W. Briggs, [¶56,086 P-H Memo TC] 1956, 15 CCH Tax Ct. Mem. 440; *accord*, Divine v. United States, W.D. Tenn. 1962, 62-2 U.S. Tax Cas. 85,589; Sohmer & Co., Inc. v. United States, S.D.N.Y. 1949, 86 F. Supp. 670, 671; Wobbers, Incorporated, 1932, 26 B.T.A. 322; *see* Pittsfield Coal & Oil Company Incorporated, 1966, 25 CCH Tax Ct. Mem. 11.

This result facilitates the basic policy of Section 351.[10] Arent, Reallocation of Income and Expenses in Connection

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10. In general, cases which have attributed income to the transferor involve circumstances not present in the record before the court:

Commissioner v. Griffiths, 7 Cir., 103 F.2d 110, aff'd, 1939, 308 U.S. 355, 60 S.Ct. 277, 84 L.Ed. 319, is a case in which the taxpayer devised an intricate tax-avoidance scheme to use a controlled corporation as a conduit to defer immediate recognition of amounts paid in settlement of a claim.

In Brown v. Commissioner, 2 Cir. 1940, 115 F.2d 337, the taxpayer personally received payment which he then endorsed to the corporation. In addition, the court found the corporation to be a sham the sole purpose of which was tax avoidance.

Clinton Davidson, 1941, 43 B.T.A. 576, held that a life insurance broker who transferred his going business to a controlled corporation whose agent he then became for the purpose of procuring insurance contracts was personally taxable on commissions generated by such contracts because he had earned them; the con-

with Formation and Liquidation of Corporations, 1962, 40 Taxes 995, 996; Biblin, supra, at 407; Burke, supra, at 795; Hickman, supra, at 977-83; White, supra, at 46; Worthy, IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations, 1970, 32 J. Tax. 88, 90. *But see* Note, 38 U.Cin.L. Rev., supra, at 112-13. Moreover, it is especially apposite because the partnership operated a busi-

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Note 10—*Continued*

tracts were treated as his business; he and not the corporation was licensed as an insurance broker; insurance companies, as a general rule, decline to appoint corporations as agents; and Davidson personally received payment which he then endorsed to the corporation.

Adolph Weinberg, 1965, 44 T.C. 233, aff 'd per curiam sub nom. Commissioner v. Sugar Daddy, Inc., 9 Cir. 1967, 386 F.2d 836, cert. denied, 1968, 392 U.S. 929, 88 S.Ct. 2282, 20 L.Ed.2d 1388, involves a cash-method transferor who directed his obligors to deposit proceeds due him from the sale of crops into the accounts of a number of controlled corporations. The court found the transferor taxable with respect to such proceeds because he had performed all services upon which the right to collection depended and because no plausible business purpose was shown for the existence of the corporations except as shells or conduits for sales proceeds. The foregoing cases illustrate, inter alia, the principle that income will not be shifted to the transferee if it appears that the exchange was motivated primarily by tax avoidance rather than being made for a legitimate business purpose. This requirement will not be found in the language of Section 351, but it appears to be fundamental to the provision. 3 Mertens, Law of Federal Income Taxation Section 20.46 at 127-33; see Blanc, The Tax Treatment of Reserves Upon a Change in the Form of Doing Business, 1967, 19 U.So.Cal. Tax Inst. 433, 474 n. 108; Lyon and Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case, 1962, 17 Tax L.Rev. 293, 425-26. Weinberg is troublesome because its language implies that the assignment-of-income doctrine might apply regardless of whether the primary purpose of the transfer is tax avoidance. Nevertheless, this court believes that Weinberg is properly limited to its facts. See Biblin, supra, at 391-94. Since both parties agree that Hempt Bros., Inc. received the assets of its predecessor in an exchange made for a legitimate business purpose in which tax avoidance played no part, attribution pursuant to the assignment-of-income doctrine is improper.

ness in which expenses were paid and income was earned in the accounting period prior to that in which collections were made and income was realized. Under these circumstances, taxation to the partnership would deter incorporation by generating a significant amount of taxable income for which there might be no off-setting deductions: Matching expenses of post-incorporation collections would already have been deducted, and expenses subsequent to incorporation would be deductible by the transferee. Weiss, Problems in the Tax-free Incorporation of a Business, 1966, 41 Indiana L.J. 666, 681 & n.65. In addition, it seems anomalous to require the partnership to account for income which it never received and to which it cannot gain access without the declaration of a taxable dividend. Biblin, supra, at 408; Burke, supra, at 795; Tritt and Spencer, Current Tax Problems in Incorporation of a Going Business, 1958, 10 U.So.Cal.Tax Inst. 71, 95.

In support of its contention, plaintiff relies upon the persuasive force of the application of the assignment-of-income doctrine to transactions the tax consequences of which are regulated by Section 311,[11] Section 336[12] and

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11. Int. Rev. Code of 1954, Section 311. The legislative history of the provision makes explicit that it is not intended to alter the principle enunciated in Commissioner v. First State Bank of Stratford, 5 Cir. 1948, 168 F.2d 1004, viz., that the assignment-of-income doctrine applies to a corporation which declares a dividend the substance of which is the right to receive ordinary income. S.Rep. No. 1622, 83rd Cong., 2d Sess. 247 (1954). No similar endorsement appears in either the legislative history or the cases regarding Section 351.

12. Int. Rev. Code of 1954, Section 336. This section and Section 311 are intended to be parallel provisions; to properly implement the legislative intent, the Bank of Stratford rule should be consistently applied to both of them. Williamson v. United States, Ct.Cl. 1961, 292 F.2d 524, 155 Ct.Cl. 279; Lyon and Eustice, supra, at 396-97. Furthermore, a failure to attribute ordinary income to the distributing corporation might yield complete tax avoidance in many cases: The corporation could not be taxed on amounts collected because its existence would have terminated and its property would have passed to the shareholders; the shareholders might acquire a

Section 337.[13] However, other analogies are more instructive,[14] especially those involving corporate reorganization.[15]

Note 12—*Continued*

stepped-up basis in the distributed income items which would allow them to amortize market value against income as collections were made. Blanc, supra, at 451-52. This result does not obtain with respect to Section 351 because the transferee's basis is assessed with reference to that of its predecessor pursuant to Section 362.

13. Int. Rev. Code of 1954, Section 337. The purpose of Section 337 is to eliminate the problem exemplified in Commissioner v. Court Holding Co., 1945, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981, and United States v. Cumberland Public Service Co., 1950, 338 U.S. 451, 70 S.Ct. 280, 94 L.Ed. 251, in order to permit the same tax consequences to a liquidating corporation whether it sells its assets or distributes them to its shareholders for sale. S.Rep. No. 1622, 83rd Cong., 2d Sess. 258 (1954). Since the provision was enacted to eliminate a formalistic inequity rather than to create one, the assignment-of-income doctrine is properly applied to Section 337 in the same manner as it applies to Section 336. Commissioner v. Kuckenberg, 9 Cir. 1962, 309 F.2d 202. In addition, its legislative history indicates unambiguously that Congress did not intend to exempt from corporate taxation income from sales in the ordinary course of business. S.Rep. No. 1622, 83rd Cong., 2d Sess. 259 (1954). Since the underlying operations which generate ordinary income are not exempt, accounts receivable arising therefrom are properly taxable to the corporation. Note, Tax-free Sales in Liquidation Under Section 337, 1963, 76 Harv.L.Rev. 780, 795.

14. For example, Sections 1245(b)(3) and 1250(d)(3) expressly exclude the Section 351 exchange from recapture of excess depreciation because the transferee receives a carryover basis in which recapture potential is preserved. This is in contradistinction to other transactions, e.g., pursuant to Sections 311, 336 and 337, in which the recapture exemption is denied when the transferee's basis and holding period are assessed independently of those of its transferor. Blanc, supra, at 443-46; O'Hara, Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders, 1972, 27 Tax L.Rev. 215, 217-18 & n. 13.

Consider, too, the treatment of installment obligations, a type of account receivable. When the Section 351 transferor has performed all the services upon which the right to payment depends, a shift of attribution with respect to future installments would seem unlikely; yet, that is the result. Lyon and Eustice, supra, at

It is also argued that taxation to the transferor will have no deleterious effect on incorporation because a rational taxpayer is unlikely to transfer items of potential income and expense to a controlled corporation in any event due to alleged uncertainty whether the Commissioner will seek to apply the assignment-of-income doctrine; whether transferred accounts payable will be deductible by the transferee upon payment,[16] and whether gain will be recog-

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427. Not only is the exchange not deemed a "disposition," but any post-transfer amounts received in payment have the same character to the transferee which they would have had in the hands of the transferor. Treas. Reg. Sections 1.453-9(c)(2) (1958) and 1.453-9 (c)(3) (1958). In particular, amounts collected in excess of basis are taxable as profit to the transferee. Divine v. United States, W.D.Tenn. 1962, 62-2 U.S. Tax Cas. 85,589; Wobbers, Incorporated, 1932, 26 B.T.A. 322; H.Rep. No. 1860, 75th Cong., 3d Sess. 29 (1938).

15. Int. Rev. Code of 1954, Section 381. Both cases and commentators recognize the close relationship between Section 351 and the reorganization provisions. Helvering v. Cement Investors, Inc., 1942, 316 U.S. 527, 533-34, 62 S.Ct. 1125, 86 L.Ed. 1649; Blanc, supra, at 473-74 & n. 108; Bonovitz, Restoration to Income of Bad Debt Reserves, 1966, 44 Taxes 300, 307-08. The exclusion of Section 351 from those transfers to which Section 381(c) applies creates no negative pregnant with respect to the incidence of taxation under the former section. H.Rep. No. 1337, 83rd Cong., 2d Sess. A135 (1954); S.Rep. No. 1622, 83rd Cong., 2d Sess. 276-77 (1954); White, supra, at 38 n. 8. To the contrary, the philosophy of reorganization is that the propriety of carryover attribution should depend upon economic reality and substance rather than upon the form of a transaction. H.Rep.No. 1337, 83rd Cong., 2d Sess. 41 (1954); S.Rep.No. 1622, 83rd Cong., 2d Sess. 52 (1954). Presumably, a similar concern should animate analysis of consequences pursuant to Section 351.

16. See, e.g., Merchants Bank Bldg. Co. v. Helvering, 8 Cir. 1936, 84 F.2d 478.

On March 1, 1957, the Board of Directors of Hempt Bros., Inc. resolved to acquire the partnership's receivables, payables and inventory in exchange for stock. The corporation does not contend that it was disallowed deductions as payments on transferred accounts payable were made. Rather, it argues that it has been the policy of the Internal Revenue Service to challenge deductions

nized upon the exchange itself to the extent that transferred liabilities exceed the adjusted basis of transferred assets.[17]

This is without merit. In many cases, the withholding of accounts receivable would substantially impair corporate operations by making it difficult to meet working capital requirements. See Tritt and Spencer, supra, at 95; cf. Bittker, supra, at 7. Additionally, the policy of Section 351 reflects a realistic awareness that the incorporating entity is itself likely to perceive the transaction as a formal change which has little impact upon continuity of operation: the more natural inference is to simply assume the transfer of payables and receivables. However, a more basic problem is that plaintiff's predecessor did precisely that which is now asserted to be irrational. Assuming arguendo that there exist circumstances in which it makes sense to withhold income items from a controlled corporation, this hardly mandates reversing the tax consequences which naturally arise when they are in fact transferred. The partnership could have retained its receivables; having cho-

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Note 16—*Continued*

unless closing agreements are entered into in which the transferee agrees to report collections made on accounts receivable as income, and that this policy represents a fatal inconsistency with respect to defendant's argument that there exists a continuity of interest and operation between parties to a Section 351 exchange.

The court disagrees. It is true that the non-deductibility of transferred payables would deter the incorporation of a going business. However, the purpose of the closing agreement is merely to facilitate a proper matching of revenue and expense to preclude duplication or omission of items of income and deduction. Burke, supra, at 797; Hennessey, Accounting for a Transfer of Assets: Taxable vs. Nontaxable Acquisitions, 1972, 30 N.Y.U. Inst. on Fed. Tax. 1677, 1680-81; see Benjamin, Problems in Transition From Sole Proprietorship or Partnership to Corporation, 1968, 26 N.Y.U. Inst. on Fed. Tax. 791, 805-06; Worthy, supra, at 90-91.

17. Int. Rev. Code of 1954, Section 357(c), *as construed in* Peter Raich, 1966, 46 T.C. 604. Contra, Bongiovanni v. Commissioner, 470 F.2d 921 (2 Cir., filed Dec. 11, 1972). In this case, both parties agree that the exchange qualified for non-recognition, and no issue has been raised regarding Section 357(c).

sen to transfer them. Hempt Bros., Inc. may properly be required to accept the consequences of the exchange. Pittsfield Coal & Oil Company, Incorporated, 1966, 25 CCH Tax Ct. Mem. 11.

The court does not suggest that the Commissioner is powerless to make adjustments when necessary to prevent income distortion or tax avoidance. Indeed, the assignment-of-income doctrine might itself apply to transactions motivated primarily by tax advantage. Arent, supra, at 1002. However, the role of the doctrine seems relatively modest in this context, primarily because other means are available to reach the same result,[18] e.g., the business-purpose doctrine[19] and the Commissioner's discretionary power to allocate items of income and expense among related taxpayers. Int.Rev.Code of 1954, Section 482, *as construed in* Estate of Walling v. Commissioner, 3 Cir. 1967, 373 F.2d 190; Rooney v. United States, 9 Cir. 1962, 305 F.2d 681; National Securities Corporation v. Commissioner, 3 Cir. 137 F.2d 600, cert. denied, 1943, 320 U.S. 794, 64 S.Ct. 262, 88 L.Ed. 479.

Plaintiff's remaining arguments require only brief discussion. The decision of the Tax Court in E. Morris Cox[20] is relied upon for the proposition that amounts collected on transferred receivables cannot be attributed to the corporation because to do so would be inconsistent with its accrual method of accounting, pursuant to which income is realized when earned rather than when collected. To the contrary, Cox involved an accrual-method transferor who realized income as billings were made; the court held that the corporation was not taxable upon items billed by its predecessor prior to the transfer. This is merely an application of the principle that the amount of gain realized by a Section 351 transferee is to be assessed with reference

18. Lyon and Eustice, supra, at 424-26. See generally Rubin v. Commissioner, 2 Cir. 1970, 429 F.2d 650 [26 AFTR 2d 70-5051].

19. See note 10, supra.

20. 1965, 43 T.C. 448.

to the basis of its transferor. Since plaintiff's carryover basis in the receivables was zero, it realized income to the full extent collections were made. See, e.g., P. A. Birren & Son, Inc. v. Commissioner, 7 Cir. 1940, 116 F.2d 718.

Furthermore, the parties agree that the Commissioner properly required the corporation to change its method of accounting in order to clearly reflect income. Int. Rev.Code of 1954, Section 446(b). Permissible alternatives include a hybrid method which contains cash and accrual elements. Int.Rev.Code of 1954, Section 446(c)(4); H.Rep. No. 1337, 83rd Cong., 2d Sess. A158 (1954); S.Rep. No. 1622, 83rd Cong., 2d Sess. 300 (1945). The only requirements are that the method be used consistently and that it properly match items of income and expense. See Treas.Reg. Sections 1.446-1(c)(1)(iv)(a) (1957) and 1.446-1(c)(2)(ii) (1957). In effect, Hempt Bros., Inc. has been placed on the accrual method with respect to income earned subsequent to March 1, 1957, and on the cash method for items transferred from the partnership. The Commissioner's decision will be set aside only when it constitutes an abuse of discretion,[21] and there is no abuse when a Section 351 transferee is required to accrue post-transfer items of income and expense while reporting as income amounts collected on accounts receivable acquired from its cash-method predecessor. See Ezo Products Company, 1961, 37 T.C. 385; cf. Pittsfield Coal & Oil Company, Incorporated, 1966, 25 CCH Tax Ct. Mem. 11.

[2] Finally, it is asserted that the receivables are taxable to the individual partners because the stock which each received upon the exchange was allocated in proportion to respective interests in the partnership capital account rather than with reference to shares in transferred income items. Specifically, each partner was taxable upon twenty-five percent of partnership income, whereas individual interests in the partnership capital account and in plaintiff's

21. See, e.g., Commissioner v. Joseph E. Seagram & Sons, Inc., 2 Cir. 1968, 394 F.2d 738, 743.

stock were apportioned differently. The only authority cited in support of this position is Turnbull, Inc. v. Commissioner,[22] in which it was held that the transfer of accounts receivable among related corporations for inadequate consideration in order to utilize the transferee's large net operating loss carryovers was a transparent tax-avoidance scheme which required attribution of income to the nominal seller. Even assuming that adequacy of consideration were to be evaluated relative to proportional shares in partnership income, the facts before the court do not resemble those in Turnbull, and plaintiff 's argument is rejected.

The corporation's second major contention is that it is entitled to an opening inventory of not less than $351,-266.05 for its first taxable year because the value of the stock issued in exchange for partnership property reflected the cost of transferred inventory, constituting to its predecessor the recovery of a previously-expensed item the basis of which must be restored to cost.[23] However, since this ground for recovery was not presented in the corporation's claim for refund, the court lacks jurisdiction to entertain it.

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22. 5 Cir., 373 F.2d 91 [19 AFTR 2d 609], cert. denied, 1967, 389 U.S. 842, 88 S.Ct. 72, 19 L.Ed. 2d 105.

23. Cf. Nash v. United States, 1970, 398 U.S. 1, 90 S.Ct. 1550, 26 L.Ed.2d 1.

An alternative argument originally propounded was based upon the theory that a change of accounting method initiated by the Commissioner requires that opening and closing inventory for the year of change be valued consistently. Int. Rev. Code of 1954, Section 481, *as construed in* Fruehauf Trailer Company, 1964, 42 T.C. 83. However, in its reply brief, plaintiff indicates that the only issue with respect to inventory valuation is the applicability of the tax-benefit rule. The corporation's change of position rests upon express acquiescence in the principle that Section 481 adjustments are not made to the initial opening inventory of a Section 351 transferee because it has no "preceding taxable year" within the meaning of that section. See, e.g., Dearborn Gage Company, 1967, 48 T.C. 190, 196-201. Therefore, the court does not reach this issue.

Filing of a timely refund claim is a prerequisite to the maintenance of an action to recover taxes alleged to have been improperly assessed or collected. Int.Rev.Code of 1954, Section 7422(a). It must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. Treas.Reg. Section 301.6402-2(b)(1) (1954). A corollary of the enumerated principles is that a court lacks jurisdiction of an action to recover taxes except upon ground reasonably encompassed by the claim for refund as originally filed or properly amended,[24] the purpose of this rule is to facilitate administrative determination of claims and to limit litigation to issues which the Commissioner has considered and is prepared to defend. Austin v. United States, 10 Cir. 1972, 461 F.2d 733; Herrington v. United States, 10 Cir. 1969, 416 F.2d 1029; Thompson v. United States, 5 Cir. 1964, 332 F.2d 657; Carmack v. Scofield, 5 Cir. 1953, 201 F.2d 360 [43 AFTR 154]; Tompkins v. United States, Ct.Cl. 1972, 461 F.2d 1304; Union Pacific

24. See Real Estate-Land Title & Trust Co. v. United States, 1940, 309 U.S. 13, 60 S.Ct. 371, 84 L.Ed. 542; Austin v. United States, 10 Cir. 1972, 461 F.2d 733; Sid W. Richardson Foundation v. United States, 5 Cir. 1970, 430 F.2d 710, cert. denied, 1971, 401 U.S. 1009, 91 S.Ct. 1251, 28 L.Ed.2d 544; Herrington v. United States, 10 Cir. 1969, 416 F.2d 1029; Thompson v. United States, 5 Cir. 1964, 332 F.2d 657; Goelet v. United States, 2 Cir. 1959, 266 F.2d 881; Fidelity-Philadelphia Trust Company v. United States, 3 Cir. 1955, 222 F.2d 379; Scovill Manufacturing Company v. Fitzpatrick, 2 Cir. 1954, 215 F.2d 567; Carmack v. Scofield, 5 Cir. 1953, 201 F.2d 360; Nemours Corp. v. United States, 3 Cir. 1951, 188 F.2d 745; Pelham Hall Co. v. Carney, 1 Cir. 1940, 111 F.2d 944; Paul v. United States, S.D. Ill. 1971, 334 F. Supp. 1138 First National Bank & Trust Company of Chickasha v. United States, W.D. Okla. 1971, 329 F. Supp. 1147; Egan v. United States D.Del. 1971, 325 F. Supp. 1227, 1229 n.3; Lehigh Inc. v. United States, E.D. Pa. 1968, 290 F. Supp. 584; Miniature Vehicle Leasing Corp. v. United States, D. N.J. 1967, 266 F. Supp. 697; Schuylkill Haven Trust Company v. United States, E.D. Pa. 1966, 252 F. Supp. 557; Tompkins v. United States, Ct.Cl. 1972, 461 F.2d 1304; Union Pacific Railroad Company v. United States, Ct.Cl. 1968, 389 F.2d 437, 182 Ct.Cl. 103.

Railroad Company v. United States, Ct.Cl. 1968, 389 F.2d 437, 182 Ct.Cl. 103.

Plaintiff does not argue that its tax-benefit theory of recovery was presented to the Commissioner.[25] Instead, this is asserted to be irrelevant since the Commissioner is alleged to have been apprised of all the operative facts upon which the new theory depends and since, in any event, the refund claim is not intended to be a legal brief in which the taxpayer is required to elaborate all theories upon which the claim is based.

To the contrary, the Commissioner is required to examine only those points to which his attention is necessarily directed,[26] and this is especially apposite here be-

25. On June 24, 1965, plaintiff filed a claim for refund which, in pertinent part, is as follows:

"The taxable income of Hempt Bros., Inc. (the taxpayer-claimant herein) for its fiscal year ended February 28, 1958 has been accordingly overstated as follows:

(a) By reason of Internal Revenue Service's failure to eliminate March 1, 1957 inventories of stone, sand and gravel from taxable income $351,266.05. . . ."

The corporation amended its claim on July 9, 1965:

"Reference is made to claim for refund filed June 24, 1965 with respect to the above period. This 'Amendment to Claim' is filed in further explanation and amplification of one of the issues set forth in said claim.

"In respect of '(a)' on page 3 of the rider attached to taxpayer's claim for refund (failure to eliminate March 1, 1957 inventories of stone, sand and gravel from taxable income) filed on June 24, 1965, the Internal Revenue Service was in error because for purposes of accounting, it was inconsistent in its treatment of taxpayer's inventory for said period.

"The Internal Revenue Service changed taxpayer's method of accounting from a cash basis method to an accrual basis for the period March 1, 1957 to February 28, 1958 and for all taxable years subsequent thereto. The Internal Revenue Service, pursuant to this change, made an 'Inventory Adjustment' for the period of March 1, 1957 to February 28, 1958 whereby it set off against taxpayer's cost of sales the amount of $258,201.35, which amount constituted 'the value of stone, sand and gravel produced during and on hand at the end of the taxable year.' However, the Internal Revenue Service erroneously failed to include taxpayer's beginning inventory

cause the corporation's amended claim sets forth specific reasons in support of its inventory argument the natural effect of which is to induce the Commissioner to pursue quite a different line of inquiry than is relevant to the theory upon which plaintiff presently seeks to rely. Tompkins v. United States, Ct.Cl. 1972, 461 F.2d 1304, 1314-15 (Dissenting Opinion). Similarly, it is immaterial that facts which might support recovery pursuant to the tax-benefit theory were before the Commissioner when he reviewed the corporation's claim: the mere availability of information is not equivalent to notice that a specific claim based thereon is being made because the Internal Revenue Service cannot be expected to discover every claim which a taxpayer might conceivably assert. Herrington v. United States, 10 Cir. 1969, 416 F.2d 1029; Nemours Corp. v. United States, 3 Cir. 1951, 188 F.2d 745; Pelham Hall Co. v. Carney, 1 Cir. 1940, 111 F.2d 994; Commercial Solvents Corporation v. United States, Ct. Cl., 427 F.2d 749, 192 Ct. Cl. 339, cert. denied, 1970; 400 U.S. 943, 91 S. Ct. 242, 27 L. Ed. 2d 247; Union Pacific Railroad Company v. United States, Ct. Cl. 1968, 389 F. 2d 437, 182 Ct. Cl. 103.

For the reasons given, plaintiff's motion will be denied, and summary judgment will be entered for defendant.

Note 25—*Continued*

of $351,266.05 in its cost of sales. Because the Internal Revenue Service included the taxpayer's ending inventory in income, it should have eliminated beginning inventory from income in order to put taxpayer on a consistent accounting method for such period (March 1, 1957 to February 28, 1958). It was in error in failing to put taxpayer on the same method of accounting with respect to both beginning and ending inventory."

In substance, this is the alternative argument which the corporation originally made and then abandoned in this action. See note 23, supra.

26. Stoller v. United States, 5 Cir. 1971, 444 F.2d 1391; Sid W. Richardson Foundation v. United States, 5 Cir. 1970, 430 F.2d 710, cert. denied, 1971, 401 U.S. 1009, 91 S.Ct. 1251, 28 L.Ed.2d 544; Schuylkill Haven Trust Company v. United States, E.D. Pa. 1966, 252 F. Supp. 557; see Nemours Corp. v. United States, 3 Cir. 1951, 188 F.2d 745.

UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA

HEMPT BROS., INC.,
Plaintiff,

v. No. 68-484 Civil

UNITED STATES OF AMERICA,
Defendant.

ORDER

Plaintiff, Hempt Bros., Inc., having moved for summary judgment in the above captioned matter, and the court having heard oral argument and having considered the briefs and supporting documents of the parties,

It is ORDERED that summary judgment for the plaintiff, Hempt Bros., Inc., is denied.

It is FURTHER ORDERED that summary judgment for the defendant, United States of America, is granted.

Chief Judge
Middle District of Pennsylvania

Dated: December 30, 1972.

UNITED STATES DISTRICT COURT
FOR THE
MIDDLE DISTRICT OF PENNSYLVANIA

CIVIL ACTION FILE No. 68-484

HEMPT BROS., INC., *Plaintiff*

vs. JUDGMENT

UNITED STATES OF AMERICA, *Defendant*

This action came on for (hearing) before the Court, Honorable Michael H. Sheridan, United States District Judge, presiding, and the issues having been duly (heard) and a decision having been duly rendered,

It is Ordered and Adjudged that pursuant to the Court's Order granting Summary Judgment for the defendant, United States of America,

It is ordered and adjudged that the plaintiff take nothing and the case be, and hereby is, dismissed with prejudice.

Dated at Scranton, Pa., this 30th day of December, 1972.

T. Harold Campion
Clerk of Court

Frank Kurdziel

By
Frank Kurdziel, Deputy Clerk

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 73-1296

HEMPT BROS., INC.,
Appellant,

v.

UNITED STATES OF AMERICA

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA.
(D.C. Civil No. 68-484)

Argued November 2, 1973

Before: ALDISERT and WEIS, *Circuit Judges*, and LATCHUM, *District Judge*.

OPINION OF THE COURT

(Filed January 14, 1974)

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ALDISERT, *Circuit Judge.*

In this appeal by a corporate taxpayer from a grant of summary judgment in favor of the government in a claim for refund, we are called upon to decide the proper treatment of accounts receivable and of inventory transferred from a cash basis partnership to a corporation organized to continue the business under 26 U.S.C. §351(a).[1] This appeal illustrates the conflict between the statutory purpose of Section 351, postponement of recognition of gain or loss, and the assignment of income and tax benefit doctrines.

The facts were wholly stipulated; therefore, they may be summarized as set forth by this government in its brief:

> The taxpayer is a Pennsylvania corporation with its principal place of business in Camp Hill, Pennsylvania. It files its federal income tax returns for a fiscal year beginning March 1.
>
> From 1942 until February 28, 1957, a partnership comprised of Loy T. Hempt, J. F. Hempt, Max C. Hempt, and the George L. Hempt Estate was engaged in the business of quarrying and selling stone, sand, gravel, and slag; manufacturing and selling ready-mix concrete and bituminous material; constructing roads, highways, and streets, primarily for the Pennsylvania Department of Highways and various political subdivisions of Pennsylvania, and constructing driveways, parking lots, street and water lines, and related accessories.

1. Sec. 351. Transfer to Corporation Controlled by Transferor.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

The partnership maintained its books and records, and filed its partnership income tax returns, on the basis of a calendar year and on the cash method of accounting, so that no income was reported until actually received in cash. Accordingly, in computing its income for federal income tax purposes, the partnership did not take uncollected receivables into income, and inventories were not used in the calculation of its taxable income, although both accounts receivable reflecting sales already made and physical inventories existed to a substantial extent at the end of each of the partnership's taxable years. Rather than using the inventory method of accounting, the partnership deducted the costs of its physical inventories of sand, gravel, and stone as incurred.

On March 1, 1957, the partnership business and most of its assets were transferred to the taxpayer solely in exchange for taxpayer's capital stock, the 12,000 shares of which were issued to the four members of the partnership. These shares constituted 100% of the issued and outstanding shares of the taxpayer. This transfer was made pursuant to Section 351 (a) of the Internal Revenue Code of 1954; . . . . Thereafter, the taxpayer conducted the business formerly conducted by the partnership.

Among the assets transferred by the partnership to the taxpayer for taxpayer's shares of stock were accounts receivable in the amount of $662,824.40 arising from performance of construction projects, sales of stone, sand, gravel, etc., and rental of equipment prior to March 1, 1957. Also among the assets transferred were physical inventories of sand, gravel, and stone, with respect to which the partnership had deducted costs of $351,266.05 and the value of which was no less than $351,266.05.

Commencing with its initial fiscal year [which] ended February 28, 1958, taxpayer maintained its books and filed its corporation income tax returns on

the cash method of accounting and, accordingly, did not take uncollected receivables into income and did not use inventories in the calculation of its taxable income. In its taxable years ending in 1958, 1959, and 1960, taxpayer collected the respective amounts of $533,247.87, $125,326.71 and $4,249.72 of the accounts receivable in the aggregate amount of $662,-824.40 (*sic*) that had been transferred to it, and included those amounts in income in computing its income for its federal income tax returns for those years, respectively.

As a result of an examination extending over a period of years, it was determined by the Commissioner of Internal Revenue, and agreed to by the taxpayer, that the use of the cash receipts and disbursements method of accounting with regard to purchases and sales, without taking into account merchandise on hand at the beginning and end of the taxable year, did not clearly reflect taxpayer's income. Accordingly, taxpayer's income was adjusted as set forth in an examination report of August 24, 1964 . . . to accrue unreported sales [accounts receivable] made during the taxable years in question and to take into account inventories in computing its cost of goods sold. In computing taxpayer's cost of goods sold under the inventory method, for the fiscal year ended February 28, 1958, the Commissioner of Internal Revenue, in conjunction with his accrual method treatment, fixed the beginning inventory of stone, sand, and gravel, which had been transferred to the taxpayer by the partnership, at zero, and the ending inventory at $258,201.35. The result was an increase in taxpayer's taxable income for the fiscal year ended February 28, 1958, in the amount of $258,201.35.

The Commissioner of Internal Revenue assessed deficiencies in taxpayer's federal income taxes for its fiscal years ending February 28, 1958, and 1959. The taxpayer

paid the amounts in 1964, and in 1965 filed claims for refund of $621,218.09 plus assessed interest.[2] The claims were disallowed in full on September 24, 1968, and the district court action was timely instituted on December 5, 1968.

The district court held: (1) taxpayer was properly taxable upon collections made with respect to accounts receivable which were transferred to it in conjunction with the Section 351 incorporation, and (2) the court lacked jurisdiction to entertain taxpayer's contention that the tax-benefit theory of recovery entitled it to an opening inventory of not less than $351,266.05, since that theory of recovery was not presented in taxpayer's claim for refund. *Hempt Bros., Inc. v. United States*, 354 F. Supp. 1172 (M.D. Pa. 1973).

I.

Taxpayer argues here, as it did in the district court, that because the term "property" as used in Section 351 does not embrace accounts receivable, the Commissioner lacked statutory authority to apply principles associated with Section 351. The district court properly rejected the legal interpretation urged by the taxpayer.

The definition of Section 351 "property" has been extensively treated by the Court of Claims in *E. I. DuPont de Nemours and Co. v. United States*, 471 F.2d 1211, 1218-19 (Ct. Cl. 1973), describing the transfer of a non-exclusive license to make, use and sell area herbicides under French patents:

> Unless there is some special reason intrinsic to . . . [Section 351] . . . the general word "property" has

2. The Commissioner of Internal Revenue assessed deficiencies in the amounts of $364,154.20 plus interest of $125,740.42, and $75,995.46 plus interest of $24,343.53 for fiscal years ending in 1958 and 1959 respectively. Taxpayer filed claims for refund of $456,218.76 plus assessed interest for fiscal 1958, $113,163.03 plus assessed interest for fiscal 1959 and $51,836.30 for fiscal 1960.

> a broad reach in tax law. . . . For section 351, in particular, courts have advocated a generous definition of "property," . . . and it has been suggested in one capital gains case that nonexclusive licenses can be viewed as property though not as capital assets. . . .
>
> We see no adequate reason for refusing to follow these leads.

We fail to perceive any special reason why a restrictive meaning should be applied to accounts receivables so as to exclude them from the general meaning of "property." Receivables possess the usual capabilities and attributes associated with jurisprudential concepts of property law. They may be identified, valued, and transferred. Moreover, their role in an ongoing business must be viewed in the context of Section 351 application. The presence of accounts receivable is a normal, rather than an exceptional accoutrement of the type of business included by Congress in the transfer to a corporate form. They are "commonly thought of in the commercial world as a positive business asset." *DuPont v. United States, supra,* at 1218. As aptly put by the district court: "There is a compelling reason to construe 'property' to include . . . [accounts receivable]: a new corporation needs working capital, and accounts receivable can be an important source of liquidity." *Hempt Bros. Inc. v. United States, supra,* at 1176.[3] In any event, this court had no difficulty in characterizing a sale of receivables as "property" within the purview of the "no gain or loss" pro-

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3. *Du Pont v. United States, supra,* at 1214, citing *P. A. Birren & Son, Inc. v. Commissioner,* 116 F.2d 718 (7th Cir. 1940), observed that nonrecognition under Section 351 has been granted for accounts receivable. In the recent case of *Thatcher v. Commissioner,* — T.C. — (42 U.S.L.W. 2228, October 30, 1973), the Tax Court reaffirmed its decision in *Raich v. Commissioner,* 46 T.C. 604 (1966), holding that accounts receivable transferred by a cash basis taxpayer to a corporation under Section 351 had a zero basis. By placing a tax basis in that which was transferred, the Tax Court by implication assumed that accounts receivable are "property" within the meaning of Section 351.

vision of Section 337 as a "qualified sale of property within a 12-month period." *Citizens Acceptance Corp. v. United States*, 462 F.2d 751, 756 (3d Cir. 1972).

The taxpayer next makes a strenuous argument that "[t]he government is seeking to tax the wrong person."[4] It contends that the assignment of income doctrine as developed by the Supreme Court applies to a Section 351 transfer of accounts receivable so that the transferor, not the transferee-corporation, bears the corresponding tax liability. It argues that the assignment of income doctrine dictates that where the right to receive income is transferred to another person in a transaction not giving rise to tax at the time of transfer, the transferor is taxed on the income when it is collected by the transferee; that the only requirement for its application is a transfer of a right to receive ordinary income; and that since the transferred accounts receivable are a present right to future income, the sole requirement for the application of the doctrine is squarely met. In essence, this is a contention that the nonrecognition provision of Section 351 is in conflict with the assignment of income doctrine and that Section 351 should be subordinated thereto. Taxpayer relies on the seminal case of *Lucas v. Earl*, 281 U.S. 111 (1930), and its progeny[5] for support of its proposition that the application of the doctrine is mandated whenever one transfers a right to receive ordinary income.

On its part, the government concedes that a taxpayer may sell for value a claim to income otherwise his own and

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4. We put aside the pragmatic consideration that the transferee-corporate taxpayer raises the argument that the partnership should be taxed at a time when the statute of limitations has presumably run against the transferor partners, who ostensibly are the stockholders of the new corporation.

5. *United States v. Basye*, 410 U.S. 441 (1973); *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972); *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Eubank*, 311 U.S. 122 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940).

he will be taxable upon the proceeds of the sale. Such was the case in *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), in which the taxpayer-corporation assigned its oil payment right to its president in consideration for his cancellation of a $600,000 loan. Viewing the oil payment right as a right to receive future income, the Court applied the reasoning of the assignment of income doctrine, normally applicable to a gratuitous assignment, and held that the consideration received by the taxpayer-corporation was taxable as ordinary income since it essentially was a substitute for that which would otherwise be received at a future time as ordinary income.

Turning to the facts of this case, we note that here there was the transfer of accounts receivable from the partnership to the corporation pursuant to Section 351. We view these accounts receivable as a present right to receive future income. In consideration of the transfer of this right, the members of the partnership received stock—a valid consideration. The consideration, therefore, was essentially a substitute for that which would otherwise be received at a future time as ordinary income to the cash basis partnership. Consequently, the holding in *Lake* would normally apply, and income would ordinarily be realized, and thereby taxable, by the cash basis partnership-transferor at the time of receipt of the stock.

But the terms and purpose of Section 351 have to be reckoned with. By its explicit terms Section 351 expresses the Congressional intent that transfers of property for stock or securities will not result in recognition. It therefore becomes apparent that this case vividly illustrates how Section 351 sometimes comes into conflict with another provision of the Internal Revenue Code or a judicial doctrine,[6] and requires a determination of which of two conflicting doctrines will control.

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6. Weiss, *Problems in the Tax-Free Incorporation of a Business*, 41 Ind. L.J. 666, 676 (1966). *See, e.g., Henry McK. Haserot*, 41 T.C. 562 (1964), *rev'd and rem'd* 355 F.2d 200 (6th Cir. 1965).

As we must, when we try to reconcile conflicting doctrines in the revenue law, we endeavor to ascertain a controlling Congressional mandate. Section 351 has been described as a deliberate attempt by Congress to facilitate the incorporation of ongoing businesses and to eliminate any technical constructions which are economically unsound.[7]

Appellant-taxpayer seems to recognize this and argues that application of the *Lake* rationale when accounts receivable are transferred would not create any undue hardship to an incorporating taxpayer. "All a taxpayer [transferor] need do is withhold the earned income items and collect them, transferring the net proceeds to the Corporation. Indeed . . . the transferor should retain both accounts receivable and accounts payable to avoid income recognition at the time of transfer and to have sufficient funds with which to pay accounts payable. Where the taxpayer [transferor] is on the cash method of accounting [as here], the deduction of the accounts payable would be applied against the income generated by the accounts receivable." (Appellant's Brief at 32.)

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7. "One of the purposes of this section [Section 202(c)(3) of the Revenue Act of 1921] was to permit changes in form [of business] involving no change in substance to be made without undue restriction from the tax laws." Note, *Section 351 of the Internal Revenue Code and "Mid-Stream" Incorporations*, 38 U. Cin. L. Rev. 96 (1969). *See*, S. Rep. No. 275, 67th Cong. 1st Sess. 11 (1921). This intention is also reflected in the report of the House of Representatives accompanying §351 of the Internal Revenue Code of 1954. H.R. Rep. No. 1337, 83rd Cong. 2d Sess. 34 (1954).

The House Ways and Means Committee recommended that non-recognition treatment be granted for incorporation, reorganization and certain other types of exchanges to "permit business to go forward with the readjustments required by existing conditions" and to prevent "taxpayers from taking colorable losses in wash sales and other fictitious exchanges." See H.R. Rep. 350, 67th Cong., 1st Sess. 10 (1921). The Senate Finance Committee added that such treatment would eliminate "many technical constructions which are economically unsound." See S. Rep. 275, 67th Cong., 1st Sess. 12 (1921).

Weiss, *supra*, 41 Ind. L.J. 666 n.4 (1966).

While we cannot fault the general principle "that income be taxed to him who earns it," to adopt taxpayer's argument would be to hamper the incorporation of ongoing businesses; additionally it would impose technical constructions which are economically and practically unsound. None of the cases cited by taxpayer, including *Lake* itself, persuades us otherwise. In *Lake* the Court was required to decide whether the proceeds from the assignment of the oil payment right were taxable as ordinary income or as long term capital gains. Observing that the provision for long term capital gains treatment "has always been narrowly construed so as to protect the revenue against artful devices," 356 U.S. at 265, the Court predicated its holding upon an emphatic distinction between a conversion of a capital investment—"income-producing property"—and an assignment of income *per se*. "The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future." *Ibid.*, at 266. A Section 351 issue was not presented in *Lake*. Therefore the case does not control in weighing the conflict between the general rule of assignment of income and the Congressional purpose of nonrecognition upon the incorporation of an ongoing business.[8]

We are persuaded that, on balance, the teachings of *Lake* must give way in this case to the broad Congressional interest in facilitating the incorporation of ongoing businesses. As desirable as it is to afford symmetry in revenue law, we do not intend to promulgate a hard and fast rule.[9]

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8. A second issue in *Fleming*, a companion case to *Lake*, raised the question whether an oil payment for real estate was a "like kind" exchange under §112(b) (1) of the Internal Revenue Code of 1939. The Court held that the exchange was not "like kind" since its effect is a transfer of future income from oil leases in exchange for real estate. There is no "like kind" requirement under Section 351. *See* note 1, *ante*.

9. The Commissioner has apparently taken the position that irrespective of the general principle that income is based upon he who earns it, other considerations should normally control Section

We believe that the problems posed by the clash of conflicting internal revenue doctrines are more properly determined by the circumstances of each case. Here we are influenced by the fact that the subject of the assignment was accounts receivable for partnership's goods and services sold in the regular course of business, that the change of business form from partnership to corporation had a basic business purpose and was not designed for the purpose of deliberate tax avoidance, and by the conviction that the totality of circumstances here presented fit the mold of the Congressional intent to give nonrecognition to a transfer of a total business from a non-corporate to a corporate form.

But this too must be said. Even though Section 351(a) immunizes the transferor from immediate tax consequences, Section 358[10] retains for the transferors a potential income tax liability to be realized and recognized upon

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351 transfers. "However, the Service's ruling policy apparently is subject to the proviso that the taxpayer enter into a closing agreement assuring that the corporation will report the income reflected in the receivables upon their collection or other disposition. It would also appear that favorable rulings will not be issued where the timing of the transfer will be such as to result in a distortion of income. For example, such a ruling presumably could not be obtained if a seasonable business were to be incorporated during the portion of the year occurring after sizeable operating expenses had been incurred but before the income attributable thereto was collected." Weiss, *supra*, 41 Ind. L.J. at 681 (footnote omitted).

10. Sec. 358. Basis to Distributees.

(a) *General Rule.*—In the case of an exchange to which section 351, 354, 355, 356, 361, or 371 (b) applies—

(1) *Nonrecognition property.*—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

a subsequent sale or exchange of the stock certificates received. As to the transferee-corporation, the tax basis of the receivables will be governed by Section 362.[11]

II.

The taxpayer contends that the court erred in ruling that its inventory argument was not reasonably encompassed within its claim for refund, and that had the court considered this contention for the fiscal year commencing March 1, 1957, the taxpayer-corporation would have been entitled to a beginning inventory of $351,266.05 instead of zero by application of the tax benefit rule.

The government restates the reason for the district court's refusal to consider taxpayer's argument but by its brief advises: "We believe it unnecessary for this Court to explore the often obscure distinction between the facts to support a claim and the theory of a claim" and that

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Note 10—*Continued*

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) *Other property.*—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

11. Sec. 362. *Basis to Corporations*

(a) *Property acquired by issuance of stock or as paid-in surplus.*—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

"[w]ithout joining in the debate over facts versus theory, examination of the substance of taxpayer's claim for inventory adjustment makes it clear that the facts asserted in its claim for refund do not support it and the agreed facts negative it." (Appellee's brief at 19.) Regardless of the procedural question, we are persuaded that appellant's tax benefit argument does not apply to this factual complex, and "[w]e pass at once to a consideration of . . . [the merits]." *B.F. Goodrich Co. v. United States*, 321 U.S. 126 (1944).

The tax benefit rule can be simply stated: If a taxpayer makes an expenditure or suffers a loss for which it takes a deduction giving rise to a reduction in its income tax and later recovers the funds or property that it has spent or lost, it must take the amount recovered as income. *Connery v. United States*, 460 F.2d 1130, 1132 (3d Cir. 1972); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399, 401-02 (Ct. Cl. 1967).

Applying this rule to the facts of this case taxpayer contends that partnership's receipt of stock in exchange for inventory previously expensed but presently valued at $351,266.05 constituted a "recovery" which stepped up the basis of the inventory from zero to $351,266.05 and that this stepped-up basis became the basis to the partnership and the corporation under Sections 358 and 362.

Relying on *Nash v. United States*, 398 U.S. 1 (1970), and the various courts of appeals decisions in *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969); *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970); *Connery v. United States, supra*, and *Citizens' Acceptance Corp. v. United States, supra*, taxpayer proceeds to equate "value" of the inventory with tax "basis" as conceptualized in Sections 358 and 362. This keystone in the taxpayer's arch of reasoning proves to be most fragile upon close inspection.

Although Justice Douglas in *Nash* addressed a transfer of receivables under Section 351(a), the Court did not have before it the critical question posed here—whether a partnership's "basis," and ultimately the corporation's

"basis," in a previously expensed inventory is equal to the "value" of the inventory when transferred.

"In *Nash* the Court held that when eight partnerships transferred their assets to eight newly formed corporations in exchange for shares in the corporations—transfers that produced no gain or loss under §351 of the Internal Revenue Code—there was no 'recovery' of the bad debt reserves under the tax benefit rule '[s]ince the reserve for purposes of this case was deemed to be reasonable and the value of the stock received upon the transfer was equal to the *net value* of the receivables. . . .' 398 U.S., at 4, 90 S. Ct., at 1552 (emphasis in original)." *Citizens' Acceptance Corp. v. United States, supra,* at 754. While it is true that Justice Douglas stated that "[a]ll that petitioners received from the corporations were securities equal in value to the net worth of the accounts transferred, that is the face value less the amount in reserve for bad debts", 398 U.S. at 4, the sole issue before the Court was whether such receipt constituted a "recovery" within the meaning of the tax benefit rule. It was not necessary for the *Nash* Court ever to reach the question of the tax "basis" in the hands of either the transferor or transferee. Thus, the taxpayer would have us read into *Nash* a holding which did not appear therein, which was not posed by the facts, and which does not inexorably nor logically follow therefrom.

Nor may the taxpayer find solace in the decisions of the various courts of appeals upon which it relies. At issue in *Anders* and *Spitalny* were inventories which had been completely expensed and therefore had a zero basis. After the inventories were sold, the liquidated corporations attempted to assert a no-gain immunity from tax liability by virtue of the operation of §337.[12] In each case the court held the

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12. §337. *Gain or loss on sales or exchanges in connection with certain liquidations*

(a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

sale proceeds would not be considered as non-recognizable gain.

We find nothing in the teachings of the Ninth and Tenth Circuits supporting taxpayer's contention that in a Section 351(a) transfer the accounting basis for property must equal the actual or market value thereof. At the time taxpayer's inventory was totally expensed on the cash basis books of the partnership that property had mercantile value in the sense as described by Justice Douglas in *Nash*, but for accounting purposes and as a tax basis it still had a zero value. The mere fact that an asset has been transferred under Section 351(a) from a partnership ownership to a corporate ownership does not in itself alter its tax basis.

We now turn to our decisions in *Connery* and *Citizens*. The *Connery* issue was whether tax benefit principles applied following recovery of previously expensed prepaid advertising. We agreed with the Commissioner in the application of the tax benefit rule because the taxpayer realized income equivalent to the value of the previously expensed advertising costs. We said that the taxpayer incurred a tax liability based on the difference between a zero basis and the amount previously expensed.

The difficulty presented in both Section 337 and Section 351 cases is that the statute expressly provides for no-gain and no-loss tax consequences by virtue of the actual liquidation or transfer. Nothing in the statutory schema permits an immunization of normal tax consequences arising out of those separate activities which may accompany a liquidation under Section 337 or a transfer under Section 351 but which are not inherently a necessary aspect of the liquidating or transferring process. The tax imposed in

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(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

26 U.S.C. §337(a).

Connery was not the result of the liquidation process *per se*; it was imposed because of the recovery of an item previously expensed. The happenstance that the recovery took place as an additional feature of the liquidating process does not immunize that recovery from normal tax consequences. The prepaid advertising expenses had a zero basis before the liquidation process began; it had the same basis during the liquidation process.

The *Citizens* issue was the extent to which the taxpayer had recovered its previously deducted bad debt reserve. Our holding in *Citizens* was simply a reiteration of the holding in *Nash*, that the receivables had to be valued on the basis of face value less bad debt reserve. *Citizens* did not involve an adjustment of the tax basis.

In the case before us, whatever may have been the actual value of the inventory at the time of the transfer, the "basis of . . . the property exchanged," Section 358(a)(1), remained the same as it appeared in the partnership's books—zero. As to the distributees, the "basis of the . . . [stock] permitted to be received under . . . [Section 351] shall be the same as that of the property exchanged"—zero. Section 358(a)(1).

As to the corporation, according to Section 362(a) "the basis shall be the same as it would be in the hands of the transferor [partnership]. . . ." This must be zero as well. Accordingly, the taxpayer cannot prevail in his contention that he is entitled to a basis for the inventory in the amount of $351,266.05.

III.

Appellant raised at oral argument a question which, on first blush, is extremely attractive and appealing. It questions the fundamental fairness of the Commissioner's action in requiring a corporation to change from a cash to an accrual basis without permitting adjustments to the predecessor partnership. We note, however, that appellant does not dispute the Commissioner's determination that its

use of the cash receipts and disbursements method of accounting with respect to purchases and sales, without taking into account merchandise on hand at the beginning and end of the year did not clearly reflect income. (Appendix at 18a).[13]

The argument is premised on the history of IRS audits of the previous partnership books, and the failure of the Commissioner to direct that the partnership change from a cash to an accrual basis. To this is added the reality that the identical partnership business was continued by the corporation with present stock ownership reflecting past partnership interests. The argument continues: requiring the corporate taxpayer to make a sudden change in accounting methods, generating huge new tax liabilities, is basically unfair to the taxpayer; that at the very least, there should now be permitted a reopening of the partnership books to allow for adjustments under 26 U.S.C. §481 so that a new basis for an opening inventory may be permitted and a distribution of increased tax liabilities shared by the previous partnership.

Where a method of accounting differs from that under

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13. Where the Commissioner has accepted over a long period of years or approved a method of accounting by a taxpayer, this fact will be given weight in determining whether the Commissioner is justified in changing the method used by such taxpayer. *Ezo Products Co.*, 37 T.C. 385, 391 (1961); *Geometric Stamping Co.*, 26 T.C. 301 (1956). The Commissioner's authority to order a change in accounting methods when the taxpayer has regularly employed a consistent method depends upon the validity of his finding that the taxpayer's method does not clearly reflect income. *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975 (6th Cir. 1951). The Commissioner is not estopped from computing a taxpayer's income on an accrual method of accounting because he has not objected to the method used by the taxpayer in his examination of prior returns. *Caldwell v. Commissioner*, 202 F.2d 112 (2d Cir. 1953). The Commissioner's regulation requiring that purchases and sales be reported on an accrual basis where it is necessary to use an inventory is one of long standing and has received the approval of the courts. *Iverson's Estate v. Commissioner*, 255 F.2d 1 (8th Cir. 1958), *cert. denied*, 358 U.S. 893 (1958).

which the taxpayer's income for a preceding calendar year was computed, Section 481(a) provides for adjustments in previous years which are determined to be necessary solely by reason of the change, in order to prevent an amount from being duplicated or omitted. Notwithstanding the adjustment provisions of Section 481(a), a corporation formed for a business purpose is a separate entity and a separate taxpayer from the stockholders who are responsible for its creation. *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). And because of the separate taxable corporate entity, it has been held that where the change in the accounting practices is ordered for the first year of the corporation's existence, the corporation had no preceding taxable year, and therefore, Section 481 is inapplicable. *Ezo Products Co., supra*, at 394. "Equally clearly, section 481 may be applied only to the petitioner [corporation] and not to make adjustments with respect to its predecessor [partnership]." *Dearborn Gage Co.*, 48 T.C. 190, 198, (1967) citing *E. Morris Cox*, 43 T.C. 448 (1965); *Ezo Products Co., supra.*[14]

Judge Tannewald's observations in *Dearborn* seem pertinent to our facts: "We recognize that, if petitioner [corporation] had never been formed, and the predecessor partnership had continued in business, and the issue before us involved a comparable change in the latter's method of

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14. "The critical question which we must resolve is whether . . . [there can be adjustments] in opening inventory for 1957. In so doing, we must decide which of two general principles applies. The first principle requires that opening inventory must be computed on the same basis as closing inventory . . . The second principle requires that, . . . in a tax free exchange such as occurred herein when the predecessor partnership transferred its assets to petitioner, the basis of the transferred assets in the hands of the latter is the same as it was in the hands of the former. In implementing this second principle, it has been held that the basis of initial opening inventory in the hands of the transferee corporation should not be adjusted in order to correct for an erroneous method of accounting for that inventory by the predecessor transferor."

Dearborn Gage v. Commissioner, supra, at 198.

accounting for overhead costs, respondent . . . would, under the applicable decisions, have been required, in making the necessary computations, to . . . [make adjustments] both in the opening inventory and closing inventory for the . . . [previous years permitted by Section 481]. Thus, petitioner—a taxpayer separate and distinct from its predecessor—appears to fare worse than its predecessor would have. We also recognize . . . the tax benefit of the deductions . . . taken by petitioner's predecessor may not have been as great as the tax burden which our rationale now requires petitioner to bear, *e.g.*, because the partners may have been in lower tax brackets or the partnership may have operated at a loss in some of the prior years. Moreover, if the ownership of petitioner's stock had changed prior to the taxable years herein involved, the economic effect of the tax benefit would not inure to, nor would the tax burden fall upon, the same persons. But these are nothing more than some of the myriad of different consequences which may result from a change to the corporate form of doing business or from the acquisition of stock of a corporation rather than corporate assets." 48 T.C. at 199-200 (footnote omitted).

Applied to this case, these principles preclude a judicial command that the Commissioner make adjustments in the predecessor business entity to supplement the direction that the new corporate taxpayer convert to an accrual basis.[15]

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15. Had these applicable principles permitted an adjustment to the predecessor partnership accounting principles, any attempt by the Commissioner to increase the tax liabilities of the partners would probably be barred by the statute of limitations. In *Pursell v. Commissioner*, 38 T.C. 263, 276, (1962) *aff'd per curiam*, 315 F.2d 629 (3d Cir. 1963), we considered and rejected the approach similar to that urged by the taxpayer here: "Petitioners' argument, if sustained, would logically require an examination of every taxable year that . . . [taxpayer] has been in business, since it appears that the sale of merchandise has always been an income producing factor. Section 481 would have to be interpreted as permitting the correction of errors long since ordinarily barred by the statute of limitations. We do not believe that Section 481 sanctions such corrections, even if they could be accurately determined."

We have carefully considered each of appellant's contentions and have concluded that the judgment of the district court will be affirmed.

A True Copy:

Teste:

M. Elizabeth Ferguson

Chief Deputy

Clerk of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 73-1296

HEMPT BROS., INC., *Appellant*

vs.

UNITED STATES OF AMERICA

(D. C. Civil Action No. 68-484)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSYLVANIA

Present: ALDISERT and WEIS, *Circuit Judges* and
LATCHUM, *District Judge*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Middle District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, filed December 30, 1972, be, and the same is hereby affirmed. Costs taxed against appellants.

ATTEST:

Thomas F. Quinn

January 14, 1974 *Clerk*

A true copy: THOMAS F. QUINN, Clerk

M. Elizabeth Ferguson

M. Elizabeth Ferguson
Chief Deputy Clerk